



HOMEOWNERSHIP

Low interest rates, stronger job growth, and rapid house price appreciation all helped to sustain the homeownership boom through its 12th year. With well over one million owners added in 2004, the US homeownership rate set a new record of 69 percent. Minorities played a key role in this growth, contributing nearly half of the net gain in homeowners. Even so, this strong progress has done little to close the minority-white homeownership gap.

After years of uninterrupted growth, the home buying market is now feeling the pinch of higher short-term interest rates (Fig. 17). Until 2004, falling mortgage interest rates helped to keep homeownership affordable even as prices escalated. But with long-term rates flat year over year and rising short-term rates lifting the cost of adjustable mortgages, first-time buyers found it more difficult to break into the market. While discounted “teaser” offers dulled some of the impact of higher short-term rates on home buying, many borrowers still saw their monthly mortgage payments go up and those with initial discounts only deferred the higher payments for a year.

HOUSE PRICE INFLATION FALLOUT

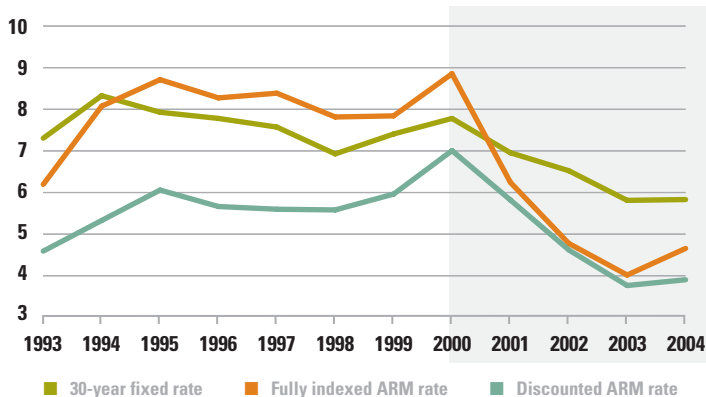
Nominal house prices were up last year in all 163 metropolitan areas tracked by Freddie Mac’s Conventional Mortgage Home Price Index. In 17 locations—most notably, Bakersfield, Las Vegas, and Riverside—nominal house prices surged by 20–30 percent in 2004, on top of 9–18 percent increases in 2003. Another 57 metros saw house price inflation in the 10–20 percent range, while 46 metros posted increases of 5–10 percent. Meanwhile, house prices in fully 159 metro markets registered real (inflation-adjusted) gains.

When interest rates were falling in 2000–3, buyers who were able to come up with the additional downpayment required could purchase a typical home without pushing their monthly payments above what they would have paid at the start of the period. Buyers who could not make the higher downpayment and instead rolled the difference into a larger mortgage would have seen their payments increase only modestly. But as rates flattened in 2004, higher prices began to take a larger toll. Even buyers able to come up with the additional downpayment required on a typical home had to pay \$70 more per month last year than if they had bought in 2003 (Table A-2). For buyers in fast-appreciating markets, the difference between buying in 2004 rather than 2003 was much more sizable, in terms of both the downpayment and the monthly mortgage payment (Fig. 18).

Rapid home price appreciation can also have negative consequences for current owners. Homeowners in communities that do not roll back their tax rates to offset the effect of rising house

Figure 17 For the First Time in Four Years, Home Buyers Have Not Had the Benefit of Falling Interest Rates

Average Annual Mortgage Rate (percent)



■ 30-year fixed rate ■ Fully indexed ARM rate ■ Discounted ARM rate
 Notes: Fully indexed adjustable rate mortgage (ARM) rate is the ARM margin rate plus the 1-year Treasury rate. Rates are averages of monthly interest rates.
 Source: Freddie Mac, Primary Monthly Mortgage Survey.

Figure 18 Homebuying Costs Have Soared in Some of the Nation's Hottest Markets



Notes: Downpayments calculated as 10% of median home price. Monthly payments based on remaining 90% of purchase price and Freddie Mac average annual interest rates on 30-year fixed mortgages. Sources: Freddie Mac Conventional Mortgage Home Price Index and Primary Mortgage Market Survey, and National Association of Realtors median house prices. Values adjusted for inflation using the CPI-U-X for All Items.

values may have to face a property tax hike. The burden of higher property tax payments falls especially hard on elderly owners with low fixed incomes.

Nonetheless, the rising tide of housing wealth has enabled owners to borrow more freely against their homes. In most cases, this means that homeowners have been able to finance their consumption with relatively low-cost debt. And because lenders are more willing to bank on homes as collateral, homeowner equity may be the only available source of capital for borrowers with poor credit records.

THE SHIFT TO ADJUSTABLE-RATE MORTGAGES

In early 2004, short-term interest rates were still well below long-term rates. As a result, homebuyers increasingly turned to adjustable-rate mortgages. On a year-over-year basis, the adjustable share of conventional mortgage originations essentially doubled from 18 percent in 2003 to 35 percent in 2004 (Table A-3).

As the year progressed, however, the spread between fully indexed adjustable- and fixed-rate mortgages shrank from nearly two percentage points to almost zero. To shore up the adjustables market, lenders increased their first-year teaser discounts from 0.4 percentage point to 1.5 percentage points. Even with these much steeper discounts, though, initial rates on one-year adjustables were still up 0.4 percentage point from 12 months earlier while rates on 30-year fixed loans barely budged.

When spreads between fixed- and adjustable-rate mortgages narrow, the adjustable-rate loans become less attractive and their share of the market usually decreases. Last year was an exception.

With lenders offering substantially lower teaser rates and home prices rising rapidly, the adjustable-rate share held firm.

Home buyers choosing an adjustable-rate mortgage could be in for payment shock if interest rates take off. Even if the rates to which mortgages are indexed do not go up, borrowers that took out loans with a one-year discount will see their rates increase by 0.4–1.5 percentage points over the course of 2005. Furthermore, because most loans are underwritten to the discounted first-year rate, homebuyers who pushed debt-to-income qualifying limits may find their new payments difficult to meet.

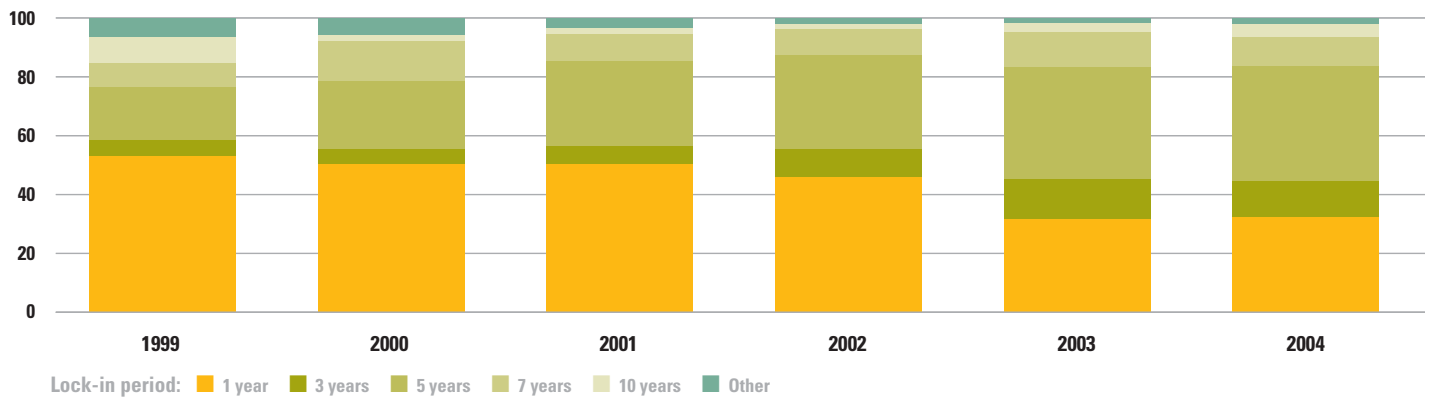
Fortunately, lenders typically shield adjustable-rate mortgage borrowers from acute payment shock by capping annual adjustments at two percentage points. In addition, a growing share of loans locks in interest rates for at least three years (Fig. 19). When the adjustable share hit its previous peak in 1994, nearly all of the loans adjusted after one year. Today, this is true for only a third of adjustable-rate mortgages. Discounts on these products are also smaller than on shorter-term adjustables, so many borrowers who took out hybrid loans with teaser rates will face only modest payment hikes after the first year.

MORTGAGE PRODUCT PROLIFERATION

While nearly half of all home purchase loans in 2004 were standard 30-year, fixed-rate mortgages, the lending marketplace has evolved considerably over the past 15 years. As recently as 1990, lenders offered mortgages at essentially a single price reflecting the term of the loan, targeting only borrowers meeting stringent credit history rules and loan-to-value and debt-to-income ratios. Not so today. Underwriting standards have become more

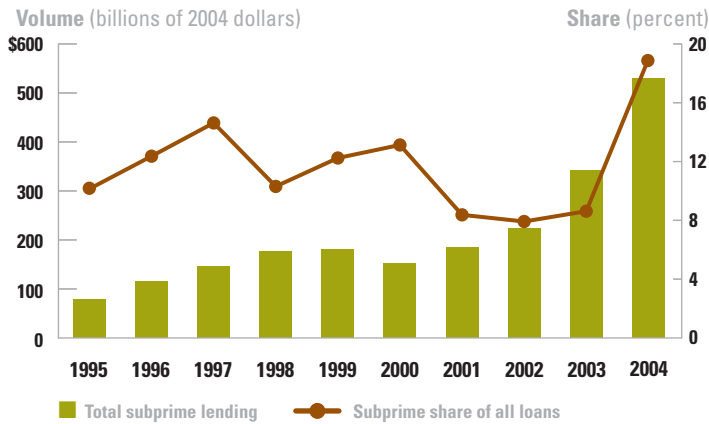
Figure 19 Adjustable Mortgage Borrowers Are Locking in Rates for Longer Periods

Share of ARM Originations (percent)



Source: Federal Housing Finance Board.

Figure 20 Subprime Lending Has Climbed Sharply



Notes: Total includes originations of first and second mortgages on 1-4 unit residential properties. Subprime loans as a share of all loans fall during periods of heavy refinancing when interest rates fall, which accounts for the drop in 2001-3 and the rebound in 2004.

Source: Inside Mortgage Finance, adjusted for inflation by the CPI-UX for All Items.

relaxed, new products have been introduced, and the industry provides credit access even to applicants who fall outside the range of prime risk.

Credit standards have been eased especially in the areas of minimum downpayments, debt-to-income ratios, and credit history. For example, zero and near-zero downpayment loans are now commonplace. As recently as 1990, only 3 percent of conventional home purchase loan originations had downpayments of 5 percent or less. That share now averages around 16–17 percent. Subprime lending has also seen meteoric growth (Fig 20). Targeted to borrowers with blemished credit histories or unusually high debt-to-income ratios, these loans have opened up credit to millions of home buyers who would otherwise be denied mortgages. To compensate lenders for the added risk of extend-

ing credit under these circumstances, borrowers are charged above-prime interest rates, often required to pay higher fees, and may face special loan conditions like prepayment penalties.

Meanwhile, low- or no-documentation, interest-only, and option-adjustable mortgages have all seen rapid growth in just the last few years. Low-documentation loans allow borrowers to supply less information to expedite application processing. For instance, automated appraisals may replace a full appraisal report and income may be stated but not verified. At the extreme, lenders waive any income or asset disclosure requirements. These so-called “no-income/no-asset” loans suit borrowers who are unwilling or uncomfortable sharing information on their financial situations. Typically, borrowers are charged higher rates or are offered these loans only if they provide a relatively large downpayment and have an unsullied credit record.

While no-documentation loans are still somewhat rare, interest-only loans have gained wide acceptance within the mortgage market. Loan Performance reports that as many as a third of home purchase loans originated in 2004 required payment of interest only. Such loans help borrowers overcome the affordability hurdle by deferring principal payments for a period of three, five, or seven years. Interest-only loans have become especially popular in the pricey metros of California, where the ratio of median house prices to median household incomes tops out at over 9 to 1.

While not nearly as popular as interest-only loans, option-adjustable mortgages provide another new financing tool for consumers. These loans usually defer interest—and sometimes even principal—payments for a specified period. In addition, they offer a wide range of adjustment periods and monthly payment choices so that borrowers can match their repayments to their cash flows.

RISK-BENEFIT TRADEOFFS

With all these mortgage product choices, and with lenders and real estate professionals motivated to help customers qualify for the homes they want, consumers need to understand the details of any loan they are offered. For many borrowers, adjustable-rate and hybrid mortgages provide a way to overcome the financial hurdle to homeownership, as well as their best financing option. Home buyers that plan to move before the interest-rate lock-in period expires benefit from the lower rate without additional risk. Even interest-only loans can be a good choice for buyers who intend to move or refinance within a short period of time, given that it takes several years to pay down substantial amounts of principal even on a standard 30-year, fixed-rate mortgage. Borrowers with interest-only loans must, however, make higher payments at the end of the deferral period.

At the same time, low downpayment loans provide an unmatched opportunity for home buyers to leverage their investment. For every one percentage-point rise in house value, a buyer who puts five percent down receives a 20-fold return on investment. The potential payback to buyers who put no money down is even more spectacular. Of course, most people who put little money down on a home do so because they have minimal savings and other wealth. Low-downpayment loans also carry a large mortgage insurance premium to cover the higher risk of default, therefore entailing higher monthly payments.

Option-adjustable mortgages are more worrisome because they can result in especially large payment shocks as deferred interest is added to the principal that must be repaid. As a result, borrowers are at risk of having loans that exceed the value of their homes. In this case, they would have to come up with cash to pay off their mortgages if they were to resell their homes.

ACCORDING TO LOAN PERFORMANCE, THE SHARE OF INTEREST-ONLY MORTGAGES SHOT UP FROM JUST A FEW PERCENT THREE YEARS AGO TO ONE-QUARTER OF ALL HOME LOANS IN 2004.

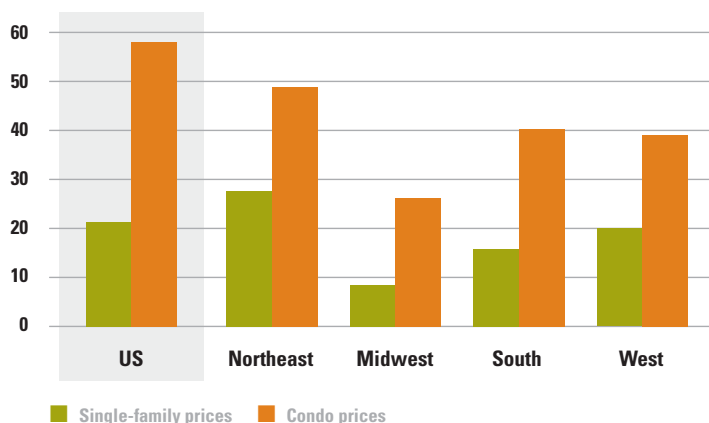
As for no-documentation loans, they may help borrowers with volatile incomes—such as those who are self-employed, working on commission, or in seasonal occupations—qualify for a mortgage, but they also expose lenders to greater risk. To cover the risk, lenders charge more. Consumers must therefore weigh their interest in keeping information private against the higher costs they will pay over the life of the loan.

Subprime loans also come at the price of significantly higher interest rates. Even a two-percentage point premium on a typical \$85,000, 30-year fixed loan, for example, adds \$18,000 in interest payments by the mid-point of the loan. In addition, subprime mortgages have higher default risk. Indeed, the Mortgage Bankers Association reports that the share of subprime loans that are 90-days delinquent or in foreclosure is running near 3.8 percent, compared with a prime loan share of just 0.5 percent. Because subprime mortgages are concentrated in low-income and minority neighborhoods, their high foreclosure rates can present a problem in these communities.

Taken together, the explosion of mortgage product offerings has greatly expanded opportunities to buy, refinance, and borrow against equity in homes. With these many new choices come different price points, fees, and conditions that demand that consumers shop carefully for a loan—a sometimes challenging task given the complexities of these unfamiliar products.

Figure 21 **Condos Have Appreciated Even More Than Single-Family Homes**

Real House Price Change, 2000-4 (percent)



Source: National Association of Realtors, median house price by region, indexed by the CPI-UX for All Items.

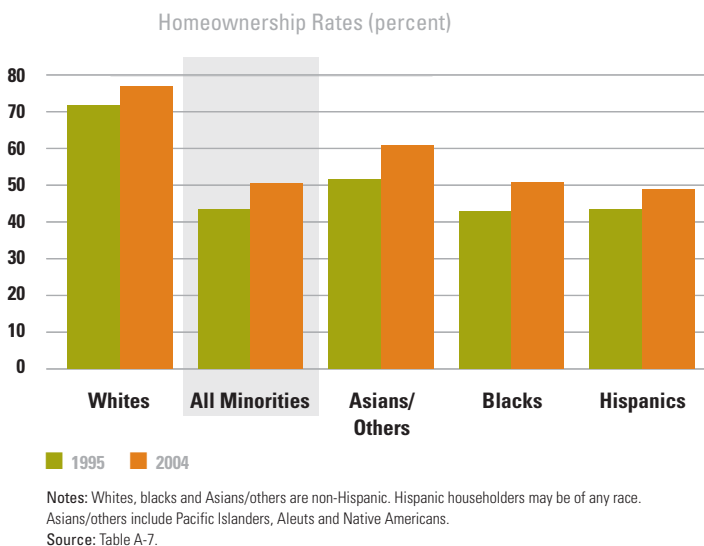
THE FLOURISHING CONDOMINIUM MARKET

With rapid house price appreciation and strong growth in single-person households, the condominium market is hot. Between 1995 and 2003, the number of occupied condos climbed by more than one-fifth from 4.4 million to 5.4 million. With demand up sharply, price inflation since 2000 has reached a stunning 57.9 percent—outstripping the otherwise noteworthy gains for conventional single-family homes by almost three to one (Fig. 21). In response, starts of multifamily condos jumped from 71,000 in 2003 to 121,000 in 2004.

While some analysts fear that speculation is driving the condo boom, investors do not appear to be behind the rapid appreciation of prices. Investors that purchase condominiums with the intent to sell in a year or two typically rent the units in the interim. But between 1995 and 2003, the number of condominiums rented out increased by only about 150,000 units, or 12 percent.

Figure 22

Despite Progress, Minority Homeownership Rates Still Lag



In fact, the overall share of condos rented out declined from 29.7 percent to 27.2 percent during this period, with the Northeast showing a particularly sharp drop from 33 percent to 26 percent. Most of the growth in the condominium supply has thus gone toward satisfying growth in owner demand.

Condominium buyers tend to be older singles or empty-nesters with slightly higher incomes than single-family homeowners. Their higher average incomes may, however, simply reflect the fact that nearly a quarter of all condominiums are located in the 20 highest-cost metropolitan areas of the country. Recent first-time home buyers favor condominium living as well. Since 1999, 9.1 percent of first-time buyers purchased condos, compared with only 7.3 percent of trade-up buyers.

MANUFACTURED HOUSING PRESSURES

Conditions are much less favorable in the manufactured housing market. Demand for manufactured units has fallen flat in recent years as changes in the availability and terms of credit have made their purchase more difficult. These changes have also reduced the cost advantages that manufactured homes once held over site-built homes and rental housing.

From 1993 to 1999, easy credit fueled more than a 25 percent increase in the number of low-income buyers of manufactured housing units. Loans to borrowers who could not repay them resulted in heavy losses for lenders. In response, lenders not only tightened terms and underwriting standards but also widened the spreads between the interest rates on loans for units sited on leased land and regular real estate. Until financing stabilizes or the industry makes more progress in shifting demand for homes

from leased to owned land, manufactured housing placements will lag below their potential.

THE OUTLOOK

With the economy poised for further growth, job gains beginning to accelerate, and interest rates likely to stay relatively low, the homeownership boom has some life left. For now, the risks in the system remain contained. Only about 1 in 20 homeowners in 2003 had an equity cushion of less than 5 percent, and prime mortgage delinquency rates and foreclosures are still relatively low. In addition, the Mortgage Bankers Association recently reported that the share of troubled subprime loans fell from 4.7 percent in the fourth quarter of 2003 to 3.8 percent in the fourth quarter of 2004.

Still, the threats to continued growth in homeownership are mounting. Repayment risk is rising as growing numbers of homeowners spend more than half their incomes on housing and/or take out adjustable-rate mortgages. In high-cost markets, the shares of borrowers with adjustable loans are especially large and the use of nontraditional mortgage products is also expanding. Equally troubling, adjustable-rate shares are not headed down even though the spread with fixed-rate mortgages is narrowing. This suggests that affordability problems, rather than better bargains, are starting to drive loan choices.

In addition, the pace of house price appreciation in many markets is unsustainable. While home prices may achieve a soft landing even in the highest-flying metros, the ride could turn out to be a bumpy one. During this past recession, home prices did not fall as they typically do when jobs are lost. As a result, prices could be headed for a more significant correction when the next major downturn occurs, especially if interest rates are high and if job losses are steeper and more concentrated than in the wake of the 2001 recession.

Going forward, homeownership gains will thus depend less on demographic demand than on a continuation of the economic conditions that have so strongly favored home buying for the past 10 years. Nonetheless, the greatest potential for growth will come from narrowing the stubborn gap in white and minority homeownership rates (Fig. 22). Even though the number of minority homeowners has been rising rapidly, the disparity with whites is still 25 percentage points (Table A-8). While the lower average age and income of minorities can explain much of this difference, greater outreach and product innovation in mortgage finance would clearly help to lift the share of minorities that own homes. ■